Audit's NEWS ANALYSIS OF SECURITIES OF REAL ESTATE INVESTMENT TRUSTS

Realty Trust Review

May 15, 1972

VOL. III, No. 9

TRUST SHARES FOR YOUR ATTENTION

INDUSTRY TRENDS

NEW TRUST OFFERINGS SLOW DOWN

Since the March quarter when eight new trusts went public and raised $192 million; only two newcomers arrived in the first six weeks of the second quarter. The lucky two were *C.I. Realty* with $65 million in shares and warrants and *U.S. Bancorp Realty and Mortgage* raising $25 million via shares and converts out of Goldman, Sachs. C.I. Realty is another sister equity trust which shares sponsorship of an already existing mortgage trust. They became more popular late in 1971 and there are now about six sister trusts. U.S. Bancorp is also an equity trust, buying Portland, Ore. properties.

As Audit Investment Research has grown, we've added to our services to investors, many of them not generally visible. To tie it all together, the brief booklet enclosed describes this total research capability and the many ways it may serve you.

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PUBLISHED TWICE MONTHLY ON THE SECOND AND FOURTH FRIDAYS SUBSCRIPTION $84 ANNUALLY GROUP RATES ON REQUEST

ADVERSE PUBLICITY, GENERAL MARKET BREAK BRING TRUST SHARES INTO BUYING RANGE

As we have been saying in recent months--and sounding like a broken, if accurate, record to many of you--trust shares aren't setting the world on fire of late. First, persistent market weakness after April 1 lead Forbes to conclude that "The boom is over for now," in trust shares, and then the overall market weakness that accelerated with President Nixon's decision to mine North Vietnam harbors drove prices down still further. We think they're in a buying range now.

First, look at trust shares in the context of the larger market. The broad based averages like the Dow-Jones Industrials and S&P Industrials went on a price rampage from New Year's Day to April Fool's Day, advancing 5.7% and 4.8% respectively. As a result performance-minded money began shifting out of REITs and into more aggressive vehicles after April 1.

But that candle burned briefly indeed. The broad market indexes began tailing off after mid-April. The speculative and volatile vehicles which are the delight of performance fund portfolio managers did what they always do in a down market, refused to perform. The overhanging threat that profit margin controls will crimp an earnings recovery, whatever the GNP figures may say, created wide uncertainty. President Nixon's hard line on North Vietnam only added to the uncertainty and drove the DJI below 925, where it was down about 5.3% from its high of 977.72 for the year. All this means that events are pushing the long-forecast rise of the DJI over the 1000 summit further into the future.

In such an environment we think you can expect a buying recovery in REIT shares fairly soon. This recovery may not be as broad-based as bulls would like but it should stem the recent slow erosion of REIT share prices and push some sturdy performers to new yearly highs.

The fundamental reason for expecting this turnaround is the fact that <u>the overall yield of about 20%-25% which is the reasonable expectation for intermediate term holdings for many major REITs now looks attractive relative to a suddenly-soggy Dow or the limp glamour issues.</u> Our overall yield is composed of dividend yield in the 8%-9% range for a selection of REIT shares plus an expectation of capital gains over the next 6 to 18 months. This expectation is based in turn upon dividend increases in this range over the next 6 to 18 months for many trusts. Moreover, the new issue game in non-REIT shares appears to have run its course for now and this should bring some funds back into the trust area, especially for new and secondary offerings.

The rush to denigrate trust shares, both by short-term oriented portfolio managers and journalists in the Forbes vein, overlooks a couple of very fundamental facts:

1. <u>Lending and ownership risks faced by trusts have been vastly over-rated.</u> The business of real estate is a risky business and anyone who says otherwise is not to be believed. The leaders of most trusts take every occasion to stress this point. The assumption of higher risk is one reason the trusts--and particularly the short-term construction and land development lending trusts--get a higher return on their investments. Expecting risk, they staff to anticipate and measure future risks so as to obtain a commensurate yield.

But risk in one loan or investment is not the same thing as risk in a total portfolio. Statistically, this is the principle of diversification which means that the chances that <u>all</u> investments in a portfolio will go sour is much more remote than the chances that any single investment will go sour. The principle is the same for mutual funds and many other collections of investments. But as we pointed out in our book THE REAL ESTATE TRUSTS: AMERICA'S NEWEST BILLIONAIRES (see Chapter 13), a portfolio of

real estate investments has quite different characteristics from a securities portfolio. The major difference is in co-variance, or the manner in which all investments move as a group. Securities portfolios tend to have high co-variance (i.e., they move up and down with the market) while real estate portfolios have low co-variance (i.e., returns from each investment do not move up and down with any market because real estate is an intensely local business).

There's one other major difference: a stock can literally go to zero, and some widely traded conglomerates of the 1968-69 bull market declined 90% or more in the years since then. But the record of real estate trusts to date is that capital is not at risk in totality and seldom at risk in major amounts for its total portfolio of investments. What is always at risk is return <u>on</u> capital--or an opportunity cost, the cost of not obtaining an expected return--and not return <u>of</u> capital.

<u>Some recent events underscore this point.</u> First Mortgage Investors, for instance, reported $2.5 million in gains on resale of foreclosures in its fiscal 1972, ending January. The widely publicized collapse of Four Seasons Nursing Centers of America in June 1970 in effect reduced return on construction loans made by trusts to that company by about 4%--but did not result in loss of capital. Whenever a foreclosure or default is reported by trusts, management almost always says it does not expect loss of principal. The record shows that through the volatile construction and real estate markets of the 1960s and so far into the 1970s, that assessment has proved correct in the vast majority of cases.

<u>In this context recent investor reaction to foreclosure and default announcements borders on the absurd.</u> Great American Mortgage, for instance, had stock trading held up a couple of hours on the New York Stock Exchange the other day because it announced a default amounting to less than 2% of its total portfolio. Other less dramatic examples of lack of investor understanding of the trust business can be cited.

<u>We have a rule of thumb investors can apply, stated before and worth repeating.</u> It is simply this: focus on trust dividend declarations instead of the flak about foreclosures or rumored foreclosures. If a trust cuts the quarterly dividend by a penny or two, don't worry. <u>But if a trust reduces its dividend by a major amount--one-third or more is a good screen--the shares should be sold immediately.</u> In the case studies analyzed in AMERICA'S NEWEST BILLIONAIRES (see Chapter 11), a major dividend cut has been the unfailing indicator of major and long-term trouble. And it has always come far enough ahead of major price declines to permit investors to exit gracefully. Currently the only trust which has made major dividend cuts is National Realty for reasons we have detailed before. National, incidentally, is an equity trust, not a mortgage lender.

2. <u>Trust profits, profit margins and dividends are not controlled.</u> This point is worth repeating in an environment in which the impact of a major economic recovery on corporate profits is being blunted by profit margin controls and Federally ordered price rollbacks. Both equity and mortgage trusts operate mainly in the commercial and industrial real estate sectors which are exempt from rent controls. Since trusts must pay 90% of earnings to shareholders in the form of dividends to retain their tax exemption, their dividends too are exempt from controls.

While operating in an uncontrolled status, the trusts are not free to wheel and deal at will. Rents, the ultimate source of a building's economic value, are subject to open market competition and right now that competition is making rent increases strictly academic in the majority of U.S. metropolitan areas. This affects the equity trusts primarily. The mortgage trusts have their rates set primarily by money market trends and as long as the Nixon Administration does not clamp controls on interest rates, their earnings will be largely a function of management's ability to generate suitable investments. In this context the mortgage trusts are among the most attractive areas of trust investment currently.

Statistics on Seven Portfolio Issues

Trust	-1972 Range-		Recent Price	% down from high	Est. Div.	Yield
Alison Mtg.	28 3/8	25 3/4	26 3/8	- 7.0	2.84	10.8%
Cabot, Cabot Land	30 3/8	25 3/8	26	- 14.4	2.00	7.7
Cam. Brown Inv.	33 3/8	30 1/4	29 3/4	- 10.9	2.76	9.3
Cont. Ill. Rlty	34 1/2	29 1/8	30 1/4	- 12.3	2.56	8.5
Guardian Mtg.	46 1/4	39 5/8	42 1/4	- 8.6	3.80	9.0
Mobile Home	15 3/4	8 1/4	12	- 23.8	0.30	2.5
Mtg. Tr. Amer.	25 1/8	22 1/2	22 3/4	- 9.5	2.16	9.5

We present below brief reviews of several trusts whose shares are included in our model portfolios and whose shares seem well situated for current investment.

CURRENT COMMENTS ON MODEL PORTFOLIO SHARES

The seven mortgage trusts discussed below provide a composite 9.4% estimated yield based upon latest dividend rates annualized. This is about 3.3% above the 6.08% yield from the Dow-Jones Utility average and about 1.6% above the yeild provided by AA-rated utility bonds. The real question is whether current quarterly dividends can be sustained at or very near present levels, and in this case we believe the answer is affirmative, as discussed below. In cases where trusts have already made small dividend reductions on a quarter-to-quarter basis, we think the expectation is for some near-term increases. The interesting fact about the seven mortgage trusts is that they have traded in relatively narrow ranges for 1970 and, as shown in the table, are trading not very far below their highs for the year. The equity trusts, Mobile Home Communities of America and Cabot, Cabot & Forbes Land Trust, tend to be more specialized situations as described below.

Mortgage Trust of America (23 3/4-NYSE) has suffered for its willingness to tell investors in detail about its one problem loan. The loan for $3 million on a San Jose apartment is currently in complex foreclosure proceedings and the lost interest is costing the trust about $0.03 per quarter. Any settlement that restores interest would thus increase earnings and dividends by about 5½% over the current quarterly rate of $0.54 for the February quarter. The apartments are renting well and the dispute is with the borrower over technical terms of the loan, and so loss of principal is not expected.

The problem loan obscures MTA's very real progress in building its portfolio at continued favorable rates over 11% and in expanding bank lines and other fund sources. Total loans funded rose from $120.8 million last November to $124.5 million in February and a current $140 million level. Commitments to fund loans already closed rose by $29 million or by nearly 50%, to $91 million during the February quarter and the unfunded commitments have continuted to rise strongly during the current quarter. The February quarter increase was achieved despite heavy declinations of loan terms on some unclosed commitments; borrower psychology has now swung to the side of locking up loans at current rates in expectation of higher rates and so this limiting factor is less of a drag to production now. MTA is advised by a unit of Transamerica Corp. and its major mortgage banking subsidiary, Bankers Mortgage Co. of California, is the nation's 13th largest mortgage banker with $867 million servicing. Currently the trust is financing portfolio growth with commercial paper and bank notes, which amounted to $68.7 million at Feb. 28, or a 1.08-1 leverage ratio over the $63.36 million shareholders' equity. The trust has 3.04 million warrants exercisable at $19 expiring in November 1974 and is currently exploring possibilities for a term loan to fund this potential $57.7 million additional equity now. Success of such an effort would increase leverage at favorable spreads and benefit earnings. MTA earnings and dividends reached $0.57 per share in the May 1971 quarter before the problem loan be-

gan cutting into earnings. The build-up in commitments and fundings leads us to expect that near-term earnings will rise moderately whatever the outcome of the problem loan foreclosure. Current prices appear to have over-reacted to the problem loan and the shares are a sound commitment.

Continental Illinois Realty (30 1/4-NYSE) declined sharply last week after trust officers visited New York analysts. The reaction appears overdone again and indeed CIR rallied to show a gain during the sharp declines of May 9. CIR portfolio commitments are rising rapidly and total fundings should be up a bit for the June quarter, reversing three quarters in which fundings were flat to down. The portfolio peaked at $110 million in June 1971 before beginning to tail off to a bottom of $98 million in the December quarter. The March quarter was up to $104.6 million. But commitments are already building and unfunded closed loans stood at $105 million at March 31, a healthy ratio. We expect that total portfolio fundings will move over the June 1971 peak this June. The portfolio yielded 11.0% in the March quarter and we expect some moderate uptick in yield in near-term quarters.

Commercial paper has continued to be the trust's main short-term financing source with $53.4 million outstanding at March 31. The paper is marketed through Lehman Bros. and is currently sold at effective rates giving the trust a 400-500 basis point gross spread over new commitments. This is a favorable spread and in view of our expectation that short-term rates should increase only moderately in near-term quarters, should provide the opportunity for continued gains in earnings for CIR. March quarter earnings of $0.66 per share were benefitted by special items which added about $0.02 per share. Our expectation is that June quarter earnings will be in the $0.66-$0.67 range with quarterly gains sustained for the rest of calendar 1972. The trust benefits from its relation with Chicago's largest commercial bank and the shares providing an estimated 8.5% yield are a buy.

Mobile Home Communities (12½-OTC) is small but one of the most dynamic equity trusts in our portfolio. It has continued to demonstrate profitable expertise in running mobile home parks while rapidly expanding its ownership of such communities. The trust now owns 26 parks having about 7,300 homesites valued at over $27 million. Rental revenue buildup has been impressive reaching $1.7 million in the six months ended Feb. vs. $861,000 in the comparable year earlier period. The first half thus nearly equalled all fiscal 1971 in this category while construction loan lending has been correspondingly reduced as the trust achieves the primary property goals it set out for when going public in August, 1969. Cash flow, in this case gross as the trust has complicated mortgage repayments covering two mortgage classes plus special payments, is used to measure financial achievements. Gross cash flow increased 12% in the half to $0.52 a share and was $0.27 in the latest quarter compared to $0.92 in fiscal 1971 (August). This year looks like close to $1.10 and we believe a growth rate of at least 15-20% annually can be sustained.

Returning to the matter of cash flow, MHC is a limited payout situation to begin with and would not pay out its depreciation after mortgage amortization (net cash flow). Additionally, in other respects the trust is beginning to find its legal status restrictive. After many months of rumors, it now admits investigating broadening its activities into other activities related to mobile homes. Unfortunately some of these activities are not open to trusts bound by tax laws on qualified trusts. The investigation will cover two alternatives: a non-qualified trust, which pays corporate tax rates, and a corporation. Some very profitable activities requiring little capital may then be available. For example, on a pilot basis the adviser has undertaken resale of some renter's mobile homes when they moved (at 10% commission). Other possibilities would also be directly related to mobile home properties and an extension of these activities, e.g., sale of accessories. We may lose a trust but gain a real estate situation. Having announced its investigation, a decision is hoped for by August.

Fundamental rental achievements are quite good. The trust's pad sites fall into three categories. Stabilized parks or park sections number 3,300 spaces and are 99.7% occupied. Those in the rent-up stage contain 1,500 spaces and are 80% occupied. This is a satisfactory level considering the new state of some of the parks. Lease-back spaces are 70% filled and while not a factor to current earnings are of future concern. This category also includes new parks. The overall competitive position within this broad business looks good. The Shiefman, Werba study sponsored by First National City Bank found mobile home park overbuilding in some sections but both the study and MHC point out qualifications: exact location, nature of the park and peculiarities within an area. Not only is MHC well situated within areas but holdings are disbursed over ten states.

It is believed present and planned financial base will permit maintaining the expansion rate for two years. On the debt side, the bank line should be increased over $3 million and will be coupled with refinancing of some first mortgages where more equity was invested to expand parks. The 313,000 shares purchasable at $10 through warrants should also come through by August, 1974 with the shares already selling 25% over exercise. The shares are reasonably priced for additional purchase at roughly ten times near-term annualized gross cash flow.

Cameron-Brown Investment Group (29 3/4-OTC) has been able to sustain earnings and dividend momentum despite the fact that it held some loans on Four Seasons nursing centers (the loan participations were bought prior to the trust's public offering to satisfy regulatory requirements that 60% of funds be committed). These sour investments caused little more than a ripple in C-BIG's growth pattern, and these problem loans have now been resolved.

C-BIG portfolio has grown steadily since inception and the funded loans and investments stood at $67.3 million at March 31, up 11.5% in the quarter. The present portfolio yielded a composite 11.5% during that quarter (10.4% in interest, 1.1% in fees). Current funding and commitments have been strong, with fundings rising to $79 million currently and commitments of about $59 million unfunded. Expected fundings in the next few months include about $27½ million in longer-term mortgage loans committed at rates of a year ago. We expect portfolio yield to decline a bit in the June quarter and earnings should be essentially unchanged from the $0.70 of the March quarter. After that earnings should respond to the higher funding and we expect that the dividend rate will end the year at about $0.70 quarterly.

Earnings per share growth has been clouded by exercise of outstanding warrants, with the $0.70 primary of the March quarter down from the $0.75 of the December quarter. More important in our view, the dividend was moved up to $0.66 in the March quarter, vs. $0.65 plus an $0.119 extra in December. The trust growth has been aided by the advisory agreement with Cameron-Brown Co., the nation's 9th largest mortgage banker with $932 million servicing. Cameron-Brown in turn is a subsidiary of a bank holding company (First Union National of Raleigh, N.C.) which is being renamed Cameron Financial Corp. With our expectation of moderate dividend increases forthcoming, the shares have current attractiveness.

Cabot, Cabot & Forbes Land Trust (26-ASE) is a success in everything but meeting its projections. Last November trust management forecast that the fully diluted earnings for the February 1972 quarter would be in the $0.52-0.53 per share range. When they came in at "only" $0.50, share prices promptly nosedived. Scaled against any other measuring rod, CCF progress in its first year has been healthy: three quarters reported so far have shown earnings (fully diluted) of $0.38, 0.45, and 0.50. Dividends have shown that same progression, $0.40, 0.45 and 0.50.

Total investments grew by $8.4 million in the February quarter to $57.7 million. Indications are that one major investment was delayed, and that final closing of this

investment was held last week. Since the Land Trust does not lend money but buys land beneath income producing properties as a long-term investment, the trust is not subject to rollover problems as outlined in our March 13 review on the subordinated land trusts. Current yield on investments is 10.87% and commitments carried 10.61% yields. This is well into the range for portfolio yields generated by short-term mortgage trusts, even though these are long-term yields not subject to the vagaries of rollover and money market variables. On this basis, the shares yielding 7.5% on current prices are a most attractive commitment.

Guardian Mortgage Investors (42¼-NYSE) just completed a record fiscal year (February) with consecutive quarterly improvements. It recently recapped its organizational strengths which form the basis for past performance and prospects for further growth. This was done before the New York Society of Security Analysts. Much credit was given to the Charter Company's parentage whose originating strength provides assured market share in obtaining construction loans with Charter providing 45% of fiscal 1972's loan production of $390 million vs. 35% the year before and expected to increase to 50% this year. This despite expanding other sources of production. The affiliation provides other impetus to the trust's earning power. Full service capability not only helps attract high-quality borrowers but also larger, better-financed projects. The organizational breadth of having Charter's offices perform supervision and functional control over single-family residental properties has permitted Guardian to be one of the few trusts to participate in this lucrative market (lucrative for those who can efficiently handle large volume). GMI committed $85 million to single-family construction loans last year at attractive rates. Overall supervision is thought to be among the tightest stemming from one of the largest mortgage bankers.

Sizable originating power has in turn enabled significant use of commercial paper through one of the largest paper houses, Lehman Bros. The trust believes it can increase its total assets to $240 million by the end of fiscal 1973 from $166 million at February, 1972. At this point, more equity will be needed. Already selling 53% over book, this will not be dilutionary. Along with volume, now at $25 million monthly and likely to go to $27 million monthly, return on equity and earnings seem headed up. Gross return seems to have bottomed out at 10½%. With the majority of loans (about 70%) tied to prime, lending rates will trend up if money rates do but with steady spreads. While growing short term, the trust is lengthening its loan portfolio maturity having committed $50 million to longer term financings. The trust is virtually free of problem loans. Its only area of concern is 9-10 houses in South Carolina which it may take back at a cost of $15-20,000.

Earnings are officially expected to increase to $4.35 a share, primary, this fiscal year compared with $3.99 and $3.67, respectively, primary and diluted in fiscal 1972. The payout last year was $3.41 a share. These shares still appear fairly valued for continued holding despite one of the best recent relative price performances.

Alison Mortgage Investment (26½-ASE) has continued to make progress despite a problem loan on which no interest has been accrued since January. The April quarter is thought to have surpassed the first quarter when the dividend was $0.71 and primary and diluted earnings $0.65 and $0.58, respectively. The trust is the lead lender to a large condominium in Miami with a $1.7 million loan. The project has stopped with $900,000 short. Foreclosure proceedings were initiated to get the sub trades started again so they would not be hurt. The lenders should not loose any principal and even interest will probably be made up. The major operations are far more pertinent. Fundings are up to $77 million from $58 million in January. The mix is heavily in Alison's specialties: 22% wraparounds and over 30% in short-

intermediates. Policy has always been away from heavy reliance on construction loans (23%) and as a result the average portfolio maturity is over 2½ years, more than twice the average for most construction loan trusts. Yield, however, has remained high, about 11½%. Trust borrowing costs have declined in the meantime since the January $20 million convertible offering which helped the credit rating. Earnings of $2.85 look attainable this fiscal year without interest contribution from the $1.7 million. The shares are above average value.

FIRST BIG MERGER IN REALTY TRUST FIELD COMPLETED

Emergence of a new *Security Mortgage Investors* marks completion of the industry's first major merger. In a nutshell, the new vehicle amalgamates the portfolios of old Security Mortgage Investors, Medical Mortgage Investors, and the piggy-back mortgage portfolio of General Electric Credit Corp. After the recapitalization, the new trust has $163.8 million assets of which $152.8 million are operating and the rest cash, etc.

	Mil.$	%
Hospital and medical buildings, from Medical Mortgage Inv.	$34.8	22.8
Junior residential mortgages from Gen. Elec. Credit Corp.	60.8	39.8
Home improvement loans from Security Mortgage	36.4	23.8
Additional home improvement loans from No. Amer. Accent	20.8	13.6
	$152.8	100.0

These loans are to be financed by shareholders' equity of $64.8 million, short-term debt of $25.5 million and long-term debt of $69.4 million, including $50 million in 7½% debentures sold in a special offering along with 1,000,000 shares and warrants to buy additional shares at $16.

The revamped trust will operate essentially as a home finance company in the REIT format. The quality of its underlying portfolio will be predominantly second mortgages securing home improvements, although some effort is expected in promoting second mortgage financing of autos and other consumer durables. Loans in this category will be originated by North American Acceptance Corp., which has 12 offices and originated the home improvement loan portfolio of old Security. In addition, a new adviser has been formed to guide the trust. The adviser is owned jointly by North American Acceptance, American Medicorp (Medical Mortgage's adviser), General Electric Credit, and the real estate subsidiary of Smith, Barney & Co., investment bankers.

Old Security had been hobbled in its operations because it had never been able to accumulate a large enough capital base to permit significant leveraging in the mode of other independent finance companies. Thus growth in portfolio and earnings per share was minuscule. The new trust has a capital base nearly four times as large and its initial portfolio is guaranteed, so investors needn't worry about problem loans. The trust has secured bank lines of $65 million and it is possible the trust could achieve leverage in the 4-1 and 5-1 range attainable by finance companies, although this must be regarded as a long-term goal.

The trust begins life earning a pro forma $1.10 per share and we believe a steady growth to about the $1.60-$1.70 range is attainable over the next 18 months or so. The shares are an attractive speculation on attainment of this objective.

General Mortgage Investments' trustees have agreed to merge that trust into Goodrich Realty Group, Ltd., a company formed by New York real estate investor Richard Cohen. Cohen is a sponsor of GIT Realty, an equity trust. General has encountered significant problem loans and as a result March quarter earnings declined to $0.20 from $0.31 a year ago. The agreement contemplates that present GMI holders would receive about 0.33 shares in the new vehicle plus a proportionate share of $13.6 million of convertible debentures. The new company would operate as a realty corporation (not a trust) and would seek listing on the American Stock Exchange. A proxy statement is to be circulated.